What's Baked In?

Summary:

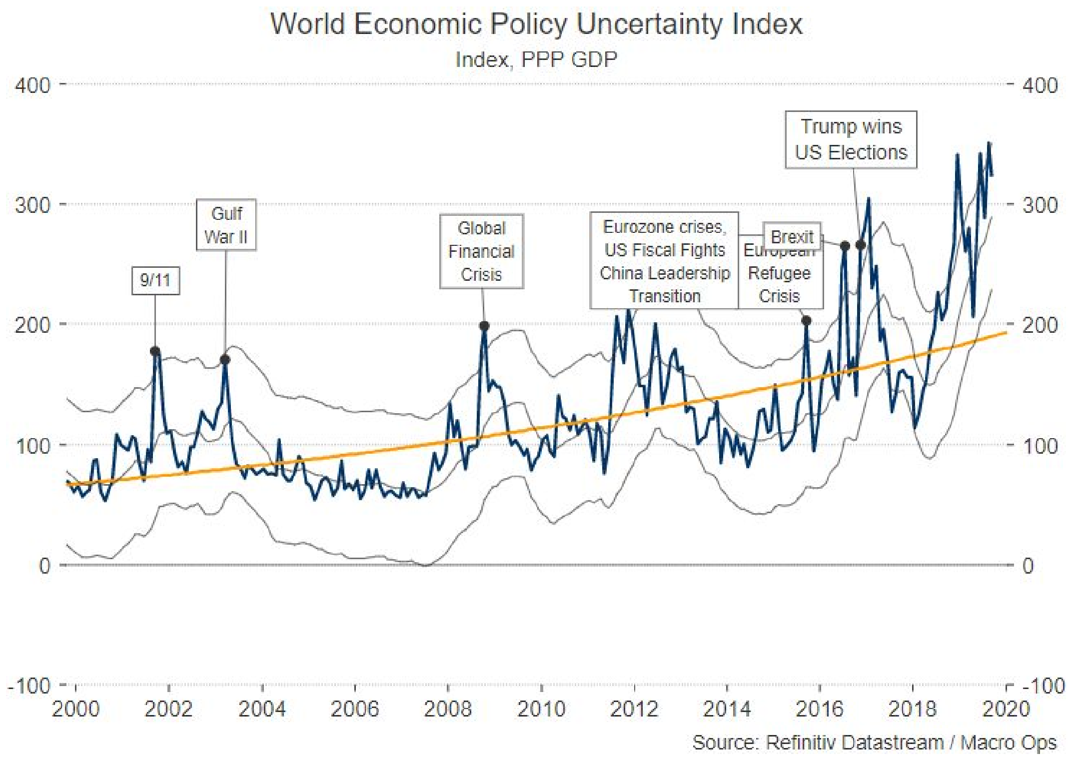
- Trade Deal: Trump throwels in the towel on the trade war, and calls for a truce
  - Why this temporary truce is bullish
- Market Trifecta (technicals, sentiment, fundamentals)
  - Was hoping for one more washout to trap the bears but following the trade developments, this is looking less likely
  - Sentiment and technicals favoring the next bullish leg in equities to start in the coming weeks
    - NASI is oversold and on the verge of giving a buy signal
    - MO Sentiment & Positioning Index just gave a buy signal
    - Investor flows show the market is hugely offsides and will be forced to rush back into stocks should equities break higher here, thus creating a bullish feedback loop
  - Earnings season starts in earnest this week. Consensus expectations are low = very easy bar to clear
- Watch USD: A break in the dollar would boost earnings, ease global fin-conditions, and drive a major trend change in EM equities

I don't want to talk too much about the "trade deal". There's plenty being written about it in the papers about whether it's a good deal or not or whether it'll even become formalized — for what it's worth, I tend to agree with Brad Sester of CFR (link 1 and 2) and think it'll get signed next month in Chile. Trump needs to shore up votes for the election and fears of a slowing economy seemed to be pushing him to make peace, at least temporarily.

The financial media's take has been broadly negative and skeptical of this "phase 1 deal". We don't so much care about the substance or lack thereof, of the deal at this stage. We just care about how this may affect markets going forward.

The important point, I think, is the fact that we're seeing a temporary de-escalation in the trade war. This will help relieve what has been an increasing headache for US — and global — executives in running their day to day operations and in trying to plan and invest for the future. It should help lead to a rebound in the horrible soft-data we've seen over the last year.

Any development that helps to even temporarily placate worries and uncertainty is good. And considering how high global policy uncertainty has been, a few positive developments no matter how minor could cause a temporary sea shift in sentiment and narrative.

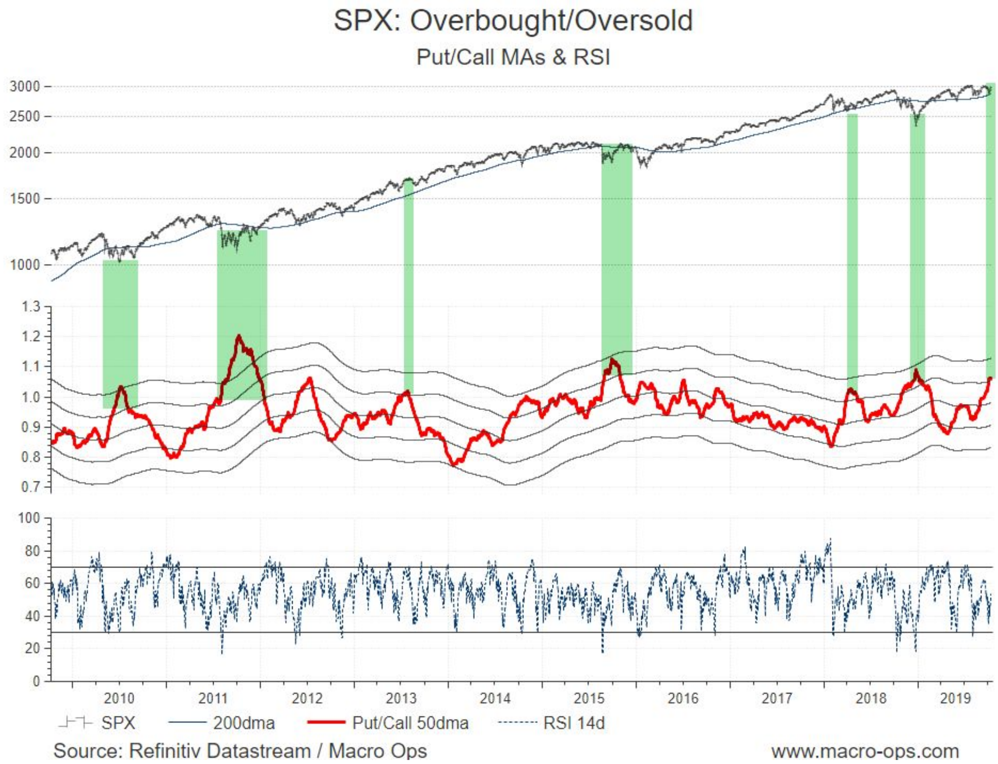


Personally, I would have liked to have seen more disappointing news come out of these trade talks to help tip the market into one more sell-off in order to *really* cement the pessimism and set a major bear trap.

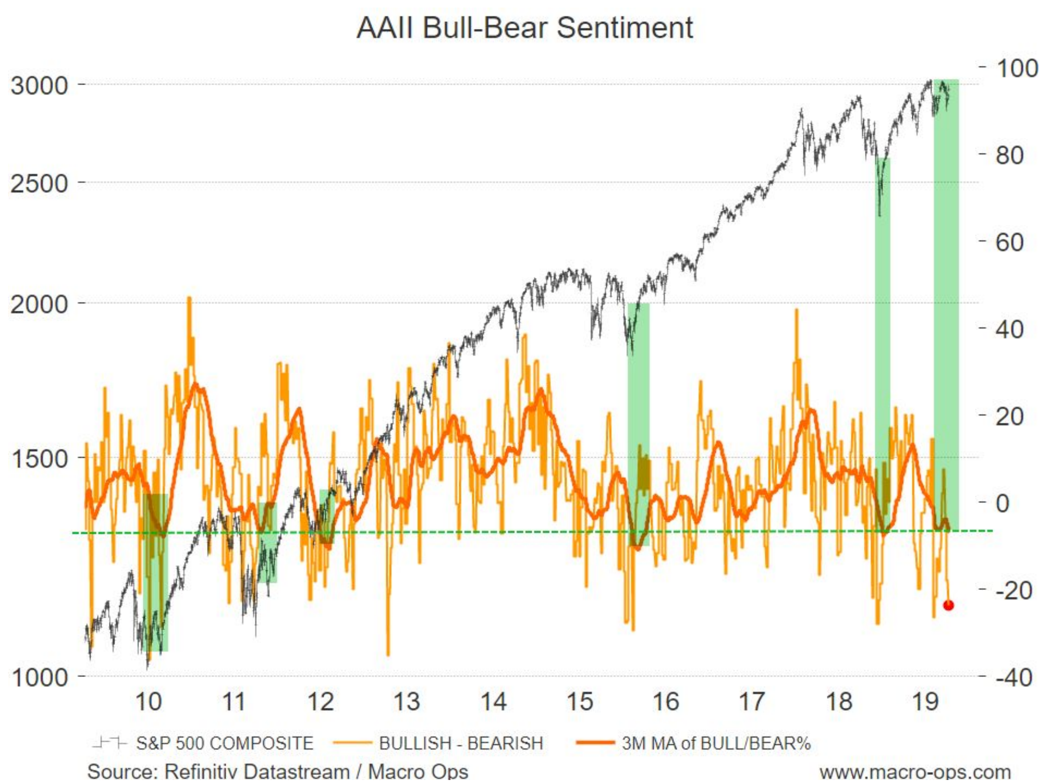
But, alas… the market doesn't care what I want. And really, the sentiment and positioning backdrop is so bearish already that we don't need another selloff to establish a base for the next leg up. On that note, [here's my weekly collection of sentiment and positioning] notes that I do every weekend. If you guys would like, I'll start sharing the updated charts and notes with you each week.

Here are the charts that stand out to me and show just how pervasive pessimism is.

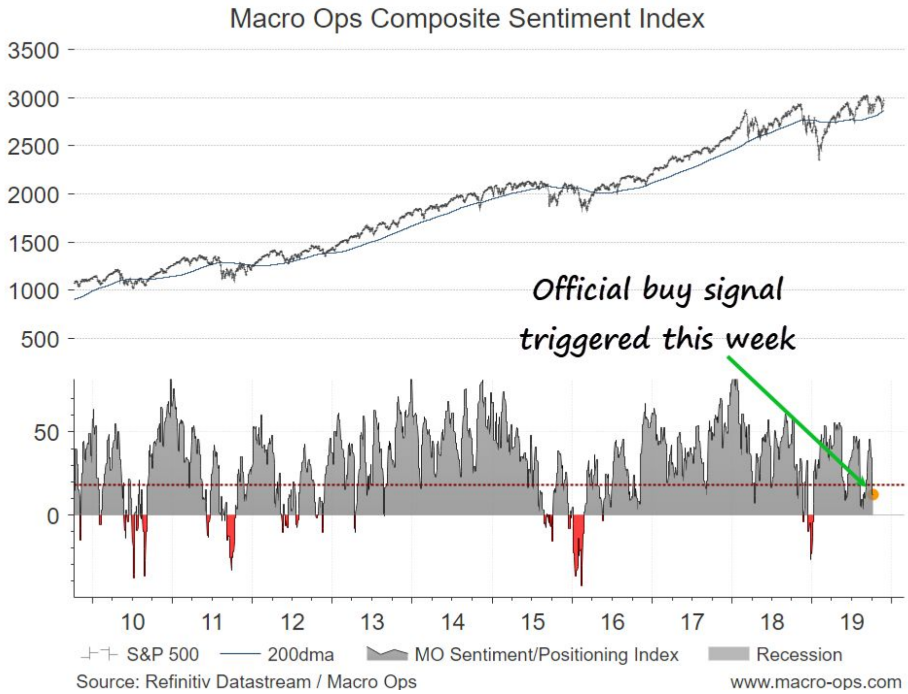
The 50-day moving average of the put/call ratio is over 1 Stdev from its rolling mean. In the past when investors have been positioned this defensively for so long, it's either coincided with or just preceded a major bottom (see green highlighted areas below).



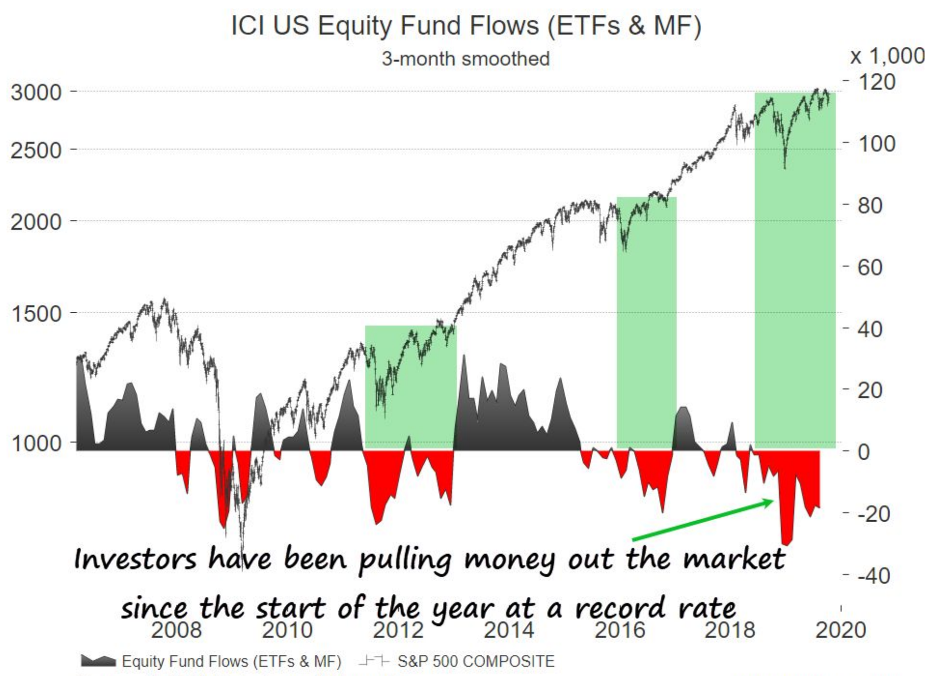
Individual investors rarely get more bearish than they are now. The AAII bull-bear spread is near historical lows and the quarterly moving average of the spread is at levels that have marked every major bottom this cycle.



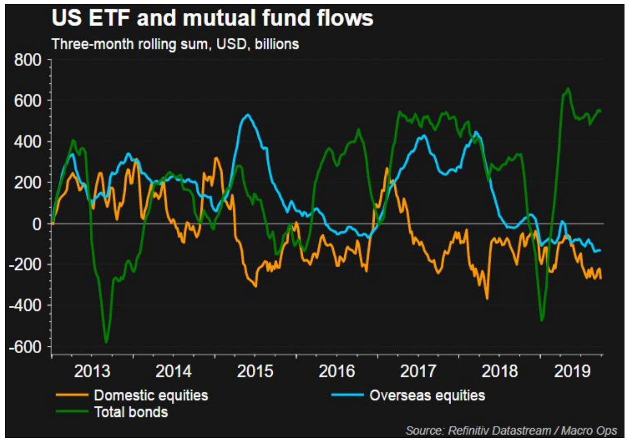
One of the things that had me on the fence last week and expecting another dip in the market was the fact that our Composite Sentiment/Positioning index was still too elevated. That's changed now. The index fell below the red line late last week giving us an official buy signal.



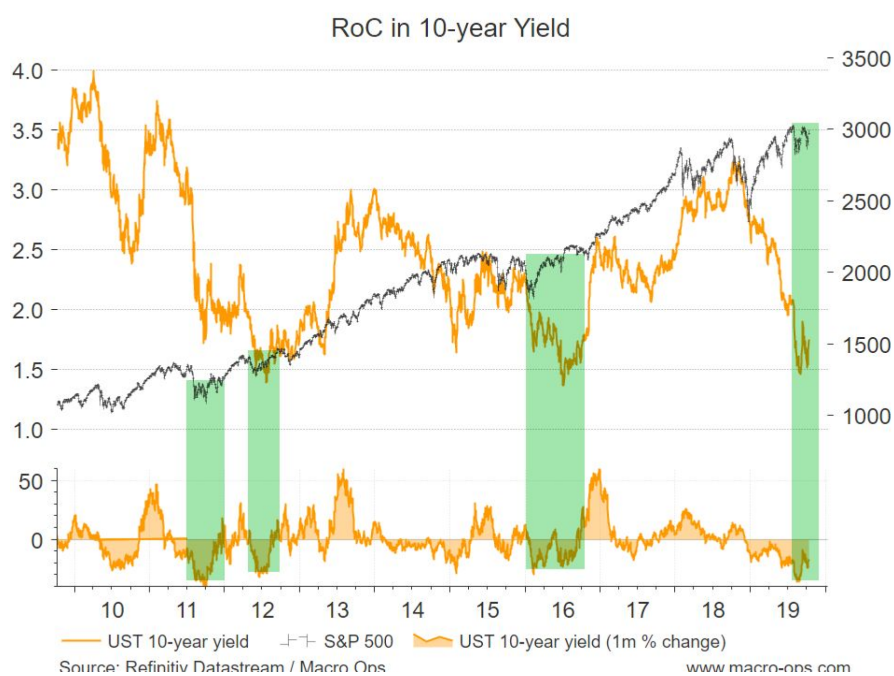
Investors have been pulling money out of stocks at record rates since the start of the year. Now, there could be a structural element to this with the minimum required distribution rule that we talked about in the last MIR. If that's the case, then this will eventually become something of concern — I'll be exploring this more in an upcoming note.



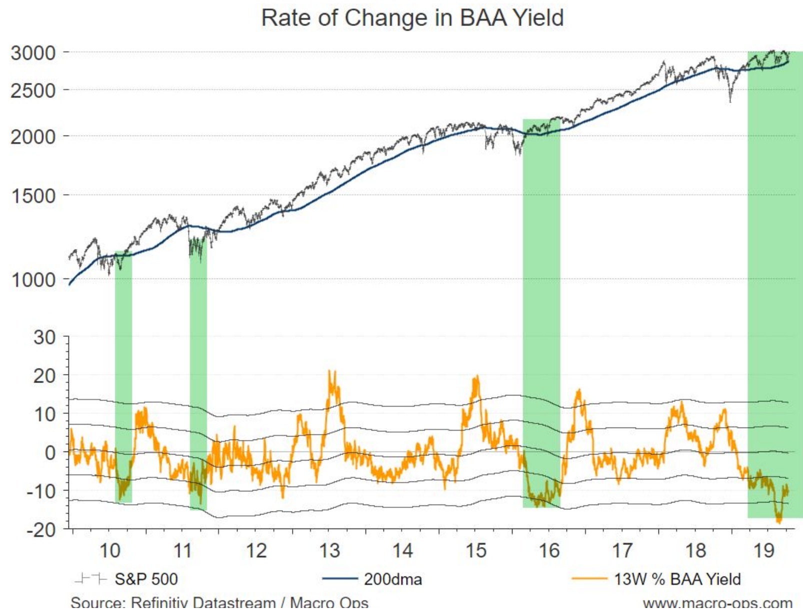
Putting all of this together, here's what the data is saying: The majority of the market is incredibly offsides and under positioned for any possibility of a rebound in the economic data. **A reversal in the year-to-date relative flows between stocks and bonds could kick off a bullish feedback loop where stocks, after mostly going sideways in the US and lower in global markets for the better part of 2-years, would begin a renewed global rally in risk assets.**



Remember, stocks and bonds compete for capital. Lower yields on bonds make stocks more attractive on a relative basis — they widen the risk premia on offer in stocks and make equity valuations more favorable in DCF calculations. This is why these two charts are so bullish. Look how much 10-year yields have come off since last year.



The 13-week RoC in BAA yields recently hit its lowest point this cycle. Again, this makes holding stocks that much more attractive.

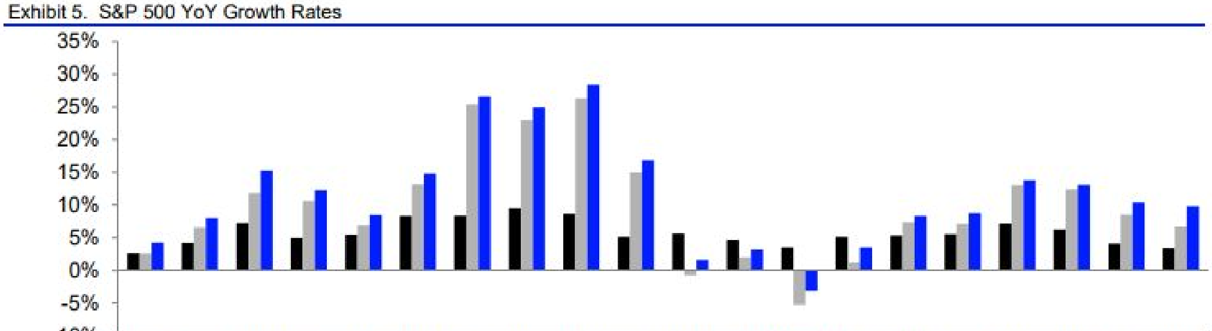


The short-term technical picture also greatly improved this past week. Both McClellan indicators (NASI and NYMO) turned higher. We'll likely see an official NASI buy signal this week. And the high/low index turned up, showing improving breadth.

The catalyst that will kick off the next trend higher will likely be better than expected earnings. Q3 earnings season starts in earnest this week.

I've been pointing out for the last few weeks that consensus expectations are low. The average analyst estimate expects EPS growth of just -3.2%. This is a very low bar to clear as there's a lot of bearishness already baked into the market.

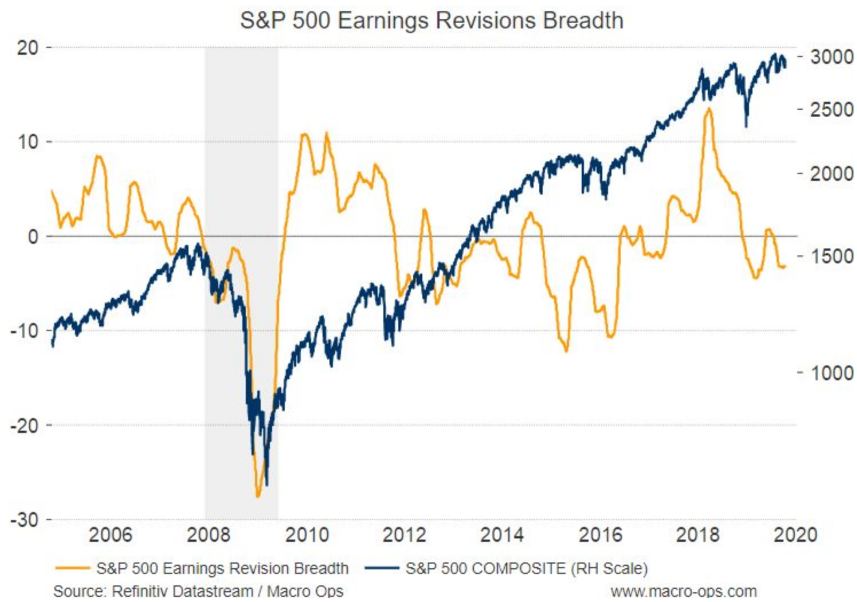
Exhibit 5. S&P 500 YoY Growth Rates



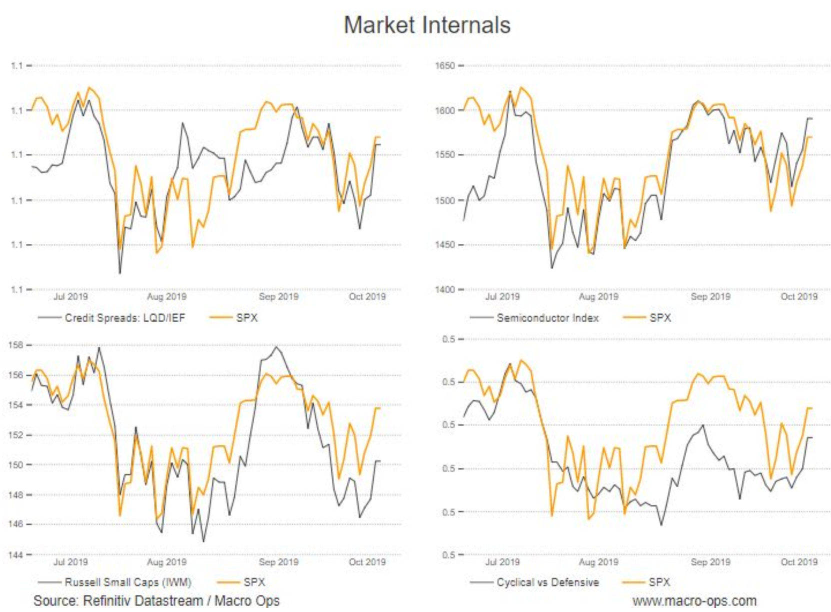
	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2
Revenue	2.6%	4.2%	7.3%	5.0%	5.5%	8.3%	8.4%	9.5%	8.6%	5.1%	5.7%	4.7%	3.5%	5.1%	5.3%	5.5%	7.2%	6.2%	4.1%	3.4%
Net Income	2.6%	6.6%	11.9%	10.6%	6.9%	13.1%	25.4%	23.0%	26.3%	15.0%	-0.8%	2.0%	-5.3%	1.2%	7.4%	7.2%	13.0%	12.4%	8.6%	6.7%
Earnings	4.3%	8.0%	15.3%	12.3%	8.5%	14.8%	26.6%	24.9%	28.4%	16.9%	1.6%	3.2%	-3.2%	3.5%	8.3%	8.8%	13.8%	13.1%	10.4%	9.8%

Source: I/B/E/S data from Refinitiv

Earnings revisions breadth will be starting from low levels. This just means that it's not going to take much to positively surprise analysts and force them to revise their expectations higher.



Lastly, check out the big change that occurred in market internals last week. LQD/IEF jumped higher, and small caps + cyclical vs defensive stocks turned up. There's a heavy roster of bank stocks (cyclical) reporting this week. They could very well set the tone for the rest of the season.



There’s a lot of great looking EM charts setting up. All they need now is a weaker dollar and I think one is one the way. I’ll be putting out a note soon explaining why I think that is but keep a close eye on this chart.

That’s all I’ve got for tonight. I’m sending out a portfolio update tomorrow. Also, a big welcome to the new members of our Collective! If you haven’t already, take some time to hop in the Comm Center and introduce yourself to the group. We’re looking forward to working and learning alongside you.

You Macro Operator,

Alex